SIA

Foreign Activity

An Analysis of Foreign Participation in U.S. Securities Markets
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Foreign Activity in U.S. Securities

"Highlights"

1. For the first time since the third quarter of 1978, foreign investors were quarterly net sellers of U.S. equities in the second quarter of 1984. Swinging from net purchasers of $555 million in the first quarter of 1984, foreign investors made net sales of $473 million of equities in the second quarter. Thus, foreign investment in U.S. equities amounted to only $82 million at the 1984 mid-year mark compared to $3.9 billion at the same time last year.

2. Foreign gross activity in U.S. equities declined 18% in the second quarter of 1984 to $28.7 billion from $35.0 billion in the first quarter. For the first six months of 1984, foreign gross transactions in equities were down 9% from the comparable 1983 figure of $70.3 billion.

3. Despite the falloff in equity investment, foreign investors did not turn to increased investment in U.S. corporate bonds. Foreign net purchases of corporate bonds were scaled back 86% in the second quarter to $67 million from $481 million in the first quarter. Foreign investors may have been waiting for the outcome of the proposed repeal of the 30% foreign withholding tax before committing to the attractive returns available on U.S. fixed income instruments.

4. In the second quarter, foreign net purchases of U.S. Treasuries jumped to $3.1 billion from $802 million in the first quarter. However, in contrast to past quarterly investment patterns, a substantial portion of net purchases, $1.3 billion, stemmed from international organizations. European investors purchased $1.5 billion, while Asian investors made net divestitures of $279 million of Treasuries.

5. The general disinterest of U.S. investors in foreign equity investment continued into the second quarter albeit at a greatly reduced pace. U.S. investors made net sales of $6 million of foreign stocks in the second quarter, compared with net sales of $354 million in the first quarter.

Introduction

A host of factors influence the foreign investor's decision to invest in U.S. equities. Predominant among these are the relative strength or weakness of the U.S. dollar and stock market and the comparative economic outlook. Despite a mixed performance by both the dollar and stock market in the first quarter of 1984, foreign investors made net purchases of $555 million. However, a robust economic picture exacerbated concerns over rising interest rates in the second quarter, further surpressing the stock market and overshadowing an exceptionally strong dollar. Thus, for the first time since 1978, quarterly foreign activity in U.S. equities resulted in net sales. Foreign investors made net sales of $473 million, bringing total foreign investment in U.S. equities to only $82 million in the first half of 1984.

The weakness of the dollar in the first quarter stimulated dollar pundits to predict its ultimate decline. The validity of these predictions was dismissed early in the second quarter, as the dollar resumed its advance against all major currencies. Nevertheless, with real GNP expanding at a healthy 7.6% annual rate, the potential for a buildup of inflationary pressures continued to worry financial markets. Also contributing to the financial markets' "jitters" was continued concern over financing the Federal deficit. Indeed, interest rates took a notable upturn during the quarter, with rates on corporate bonds rising 125 basis points to 14.5% by the end of June. In addition, the prime rate was boosted to 13.0% from 11.5% over the period. With rising interest rates undermining stock market progress, investors worldwide adopted a wait-and-see approach to equity investment.

The uneven performance of the dollar in the first quarter of 1984 was more than offset by gains against all major currencies in the second. The sharpest depreciation vis-a-vis the dollar, 11%, was suffered by the French franc. In addition, the dollar appreciated over 7% against both the Swiss franc and German mark. The pound and yen gave up about 6%, while the Canadian dollar depreciated 3%.

In contrast to the dollar, the U.S. stock market continued to slide in the second quarter. The NYSE and S&P 500 indices registered a 4% drop, cumulating in a 7% drop for each index from year-end 1983. The Dow Jones Industrial Average declined by almost 10% in the first half of the year. While the U.S. market has been on a downtrend in 1984, stock markets in some other countries registered impressive gains in the first quarter. However, Geneva's Capital International Perspective reports that seventeen out of nineteen of the world's major stock markets suffered setbacks in the second quarter.

Foreign Activity in U.S. Equities

Gross Activity

Foreign activity in U.S. equities declined 18% in the second quarter to $28.7 billion from $35.0 billion in the first quarter. Thus, total gross transactions for the first half of 1984 ($63.7 billion) are down 9% from the $70.3 billion generated by the 1983 mid-year mark. The second-quarter 1984 figure reflected a cutback in gross transactions by all major countries. Both European and Asian investors reduced activity by a significant 22%, while transactions stemming from Canada and Latin America decreased by over 6%.

TABLE I

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. EQUITIES
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$20,403	$311	$15,952	$(390)
Belgium-Luxembourg	752	20	568	0
France	2,071	(173)	1,362	134
Germany	1,995	361	1,119	(81)
Netherlands	1,148	32	1,009	(137)
Switzerland	6,490	186	4,906	(250)
United Kingdom	7,440	(130)	6,458	(138)
Canada	4,342	708	4,034	170
Latin America & Caribbean	4,693	181	4,432	144
Bermuda	1,666	144	1,376	4
Netherlands Antilles	1,873	23	2,039	153
Asia	4,998	(582)	3,900	(430)
Hong Kong	876	(80)	551	(69)
Japan	571	39	433	1
"Other Asia"*	3,254	(604)	2,439	(441)
Total All Countries	$34,983	$555	$28,693	$(473)

Source: U.S. Treasury

* Countries included are: Bahrain, Iran, Iraq, Kuwait, Oman, Qatar, Saudi Arabia, the United Arab Emirates.

Net Purchases

For the first time since 1978, foreign investors were quarterly net sellers of U.S. equities. In contrast to net purchases of $555 million in the first quarter of 1984, foreigners were net sellers of $473 million of equities in the second quarter. Net sales of $390 million by European investors were primarily responsible for the turnabout. In addition, Canadian net purchases plunged by 75% to $170 million from an unusually large $708 million in the first quarter. Latin American and Caribbean investors moderated interest in U.S. equities by 20%. On the other hand, the long-standing net divestiture pattern of the Asian countries continued in the second quarter, with net sales of $430 million.

European Investors

European investors were net sellers of $390 million of U.S. equities in the second quarter. Disenchantment with the U.S. equity market was widespread. With the exception of investors located in France and the Belgium-Luxembourg countries, investors from most major countries were net sellers. Of the net sellers, Swiss investors made the most dramatic quarterly turnaround, reversing their investment posture from net purchasers of $186 million of equities to net sellers of $250 million. On the other hand, French investors became net purchasers of $134 million in the second quarter, after making net sales of $173 million in the first.

There was earlier evidence that Swiss investors were losing their enthusiasm for U.S. equities in the first quarter of 1984, as net purchases of $186 million were based solely on one month's activity. In the second quarter, Swiss caution over U.S. equities cumulated in net sales of $250 million. Similar to the U.S. stock market, the Swiss market has been lackluster in 1984. With uncertainty over the path of interest rates and a rising dollar in the second quarter, Swiss investors may have shifted their focus to some of the innovative new instruments in their capital markets. For example, dual currency bonds, which are denominated in Swiss francs but repayable in U.S. dollars and pay a higher yield than conventional bonds, are reportedly enjoying popularity with Swiss retail investors.1/

The exceptional appetite of German investors for U.S. dollar-denominated assets, both equity and fixed income, diminished in the second quarter. German investors were net sellers of $81 million of equities in contrast to $361 million

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1/ "Another record year", Financial Times, 3/19/84.

of net purchases in the first quarter. Despite the dampening effects of the metalworkers' strike and a still high unemployment rate, the outlook for the German economy is optimistic. Consumer demand initially fueled the recovery, and strong export demand is contributing to its current momentum. Given the uncertainties about the U.S. economic outlook in the second quarter, German investors may have turned to domestic investment opportunities.

Compared with prior years, U.K. investors cooled considerably to investment in U.S. equities in 1983, making net sales of $61 million in the fourth quarter of the year. The stepped-up net selling of the first quarter of 1984 continued in the second quarter, with net sales of $138 million. London money managers are reportedly taking a cautious approach to equity investment worldwide, citing the concern over the state of the U.S. economy. Among the reasons given for increased liquidity preferences are: feelings that actions to pare the Federal deficit will not be taken until after the elections, "nervousness" over the ballooning U.S. current account, and the condition of the world banking system.2/

The only major European country with net purchases of U.S. equities in the second quarter was France. In contrast to the persistent net selling pattern since the third quarter of 1983, French investors made net purchases of $134 million. However, this was based on activity in the first two months of the second quarter as French investors resumed a net divestiture posture in June.

Canadian Investors

Canadian net purchases of U.S. equities fell 76% in the second quarter to $170 million from a significant $708 million in the first quarter. Nevertheless, with net purchases of $878 million during the first half of 1984, Canadian investors were the largest foreign purchasers of U.S. equities. While Canadian interest rates were moderately higher than U.S. rates at the beginning of the year, this differential widened sharply in the first two months of the second quarter. Canadian investors may have turned their attention to domestic fixed income investments.

2/ "Carry an Umbrella", Barron's, 8/6/84.

Asian Investors

The level of net selling of U.S. equities by Asian investors dropped 26% to $430 million in the second quarter from $582 million. Although net sales of the oil-exporting countries were reduced to $441 million from $604 million in the first quarter, total sales for the first half of 1984 represented an acceleration of the net divestiture trend of 1983. A sluggish oil market, a rapidly growing infrastructure and the Iran-Iraq war have increased the liquidity needs of the oil-exporting countries. Japanese investors have shown little interest in U.S. equity investments in 1984, with $40 million purchased through the first half of the year. However, part of the record long-term capital outflow from Japan has been invested in high-yielding U.S. Treasuries.

Foreign Activity in U.S. Corporate Bonds

Despite a falloff in U.S. equity investment, foreign investors did not turn to increased investment in U.S. corporate bonds. Foreign net purchases of corporate bonds were scaled back 86% in the second quarter to $67 million from $481 million in the first quarter. While net purchases by European investors escalated by 5% to $291 million, the investment pattern among countries was inconsistent. Activity from the Asian countries resulted in net sales of $293 million, based

TABLE II

GROSS TRANSACTIONS IN AND NET PURCHASES OF U.S. CORPORATE BONDS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$2,508	$ 276	$1,981	$291
Belgium-Luxembourg	163	(93)	126	(48)
Germany	588	20	666	292
Switzerland	454	(26)	286	14
United Kingdom	977	301	682	(8)
Asia	1,109	171	1,375	(293)
Japan	457	153	275	131
"Other Asia"	459	(27)	919	(439)
Total	$4,155	$481	$4,117	$67

Source: U.S. Treasury

mainly on net sales of $439 million by the oil-exporting countries. Thus, transactions by the major foreign investors in U.S. corporate bonds resulted in a wash, with the other foreign regions generating net purchases of $67 million. Foreign investors may have been awaiting the outcome of the proposed repeal of the 30% foreign withholding tax before committing to the attractive returns available on U.S. fixed income instruments.

Yields on U.S. corporate bonds climbed rapidly in the second quarter, increasing 125 basis points compared with 62 basis points in the first quarter.3/ U.K. corporate bond rates rose by 140 basis points, precipitating a dramatic shift on the part of U.K. investors away from U.S. corporate bonds. These investors sold $8 million of U.S. corporate bonds in the second quarter, compared to net purchases of $301 million in the first. German investors, on the other hand, stepped up net purchases to $292 million from $20 million in the first quarter.

Foreign Activity in U.S. Treasuries

In the second quarter, foreign net purchases of U.S. Treasuries jumped to $3.1 billion from $802 million in the first quarter. However, in contrast to past quarterly investment patterns, a substantial portion of net purchases, $1.3 billion, stemmed from international organizations (not shown in Table III). European investors moderated net purchases to $1.5 billion in the second quarter, while large scale net purchases by Japanese investors offset the continued divestiture of the oil-exporting countries. Estimated holdings of Treasuries by foreigners stood at $95.0 billion at the end of June.

U.S. interest rates were on an uptrend generally not matched by interest rates available elsewhere during the second quarter. Yields on short-term government instruments increased some 20 basis points, while long-term issues spurted by 116 basis points. The yield differential between U.S. and U.K. corporate bonds narrowed over the second quarter, while the differential between Treasuries increased by over 30 basis points in favor of U.S. issues. Thus, U.K. investors turned their attention from the U.S. corporate bond market to the U.S. Treasury market. U.K. investors swung from net sellers of $97 million of Treasuries in the first quarter to net purchasers of $785 million in the second. On the other hand, German investors who had been avid purchasers of Treasuries in 1983 and the first quarter of 1984, cut net purchases almost in half to $760 million from $1.5 billion in the first quarter.

3/ Interest rate analysis in this report is based on data provided in World Financial Market, Morgan Guaranty Trust Company.

TABLE III

NET FOREIGN PURCHASES AND TOTAL FOREIGN HOLDINGS
OF U.S. TREASURY NOTES AND BONDS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Net Purchases	Estimated Holdings	Net Purchases	Estimated Holdings
Europe	$1,787	$37,276	$1,463	$38,739
Switzerland	134	1,252	72	1,324
West Germany	1,546	18,836	760	19,596
United Kingdom	(97)	8,427	785	9,212
Asia	(618)	45,837	(279)	45,558
Japan	423	14,333	1,027	15,360
"Other Asia"*	(1,293)	28,139	(1,646)	26,493
All Countries	$802	$91,858	$3,143	$95,001

Source: U.S. Treasury

* Treasury has discountinued publication of the estimated holdings of the oil-exporting countries. Figures based on last published figure plus summation of quarterly data.

Japanese investors were unusually enthusiastic purchasers of Treasuries in the second quarter, thus offsetting continued net divestiture by the oil-exporting countries. Japanese investors boosted net purchases to $1.0 billion from $423 million in the first quarter, while the oil-exporting countries escalated net selling of Treasuries to $1.6 billion from $1.3 billion. High U.S. rates are reportedly attracting record outflows of Japanese capital, outweighing in recent months the current account surpluses in Japan's balance of payments.4/ Treasury data indicate that these capital outflows have been invested mainly in Treasuries, as Japanese investors showed minimal interest in other U.S. investments in the second quarter.

4/ "Tokyo shares fall, yen lowest in nearly a year", Financial Times, 7/24/84.

U.S. Investor Activity in Foreign Stocks

Caution has marked the approach to equity investment worldwide in 1984. U.S. investors began to shy away from foreign equity investment in the last quarter of 1983, swinging to net sellers of $354 million in the first quarter of 1984 despite the continued advance of stocks on some major foreign exchanges. The general disinterest in foreign equity investment has continued albeit at a reduced pace in the second quarter as U.S. investors were net sellers of $6 million.

U.S. investors made net purchases of $101 million of European stocks in the second quarter, compared with net sales of $54 million in the first quarter. Nevertheless, much of the reversal in investment posture is based on an over twofold increase in net purchases of U.K. stocks. Net purchases of U.K. stocks jumped to $90 million from $43 million in the first quarter. Even this level of activity, however, is a far cry from the $1.1 billion invested in U.K. stocks in 1983. In addition, U.S. investors sharply reduced net sales of stocks of Netherlands' companies, from $153 million in the first quarter to $42 million in the second. On the other hand, the

TABLE IV

GROSS ACTIVITY IN AND NET PURCHASES OF FOREIGN STOCKS BY U.S. INVESTORS
($ Millions)

	1984 First Quarter		1984 Second Quarter	
	Gross Activity	Net Purchases	Gross Activity	Net Purchases
Europe	$3,348	$(54)	$3,055	$101
France	311	41	258	24
Netherlands	371	(153)	264	(42)
Switzerland	339	15	237	(5)
United Kingdom	1,719	43	1,864	90
Canada	1,138	(130)	1,045	(17)
Asia	3,153	(235)	2,289	(267)
Japan	2,769	(193)	2,014	(230)
Other	469	65	621	177
All Countries	$8,108	$(354)	$7,010	$(6)

Source: U.S. Treasury

reportedly selective buying of stocks of French companies was reduced by 41% to $24 million in the second quarter from $41 million in the first. The French stock market's performance has been quite strong in light of a weak economy and internal political strife. However, the first quarter advance of the French franc was short-lived and the currency plunged some 11% vis-a-vis the dollar in the second quarter.

The pace of net selling of Canadian stocks slowed considerably in the second quarter. Net sales of $17 million were made, compared to $130 million in the first quarter. The Canadian economy has been subject to increasing pressure since the beginning of the year. Demand for natural resources, which drives the Canadian economy, has not fully picked up on a worldwide basis. In addition, the plight of financing Canada's large federal deficit was exacerbated by rising interest rates in the second quarter. However, the political change in Canada that took place in early summer, John Turner replacing Prime Minister Trudeau, has precipitated an environment that money managers believe will be more supportive of Canada's resource industries.5/ U.S. investors may have reduced net sales in anticipation of a shift in the Canadian government's policies.

Japanese stocks have been in disfavor with U.S. investors since the fourth quarter of 1983, when net sales of $152 million were made. The trend of net divestiture accelerated to $193 million in the first quarter of 1984 and further to $230 million in the second quarter. The high multiples on Japanese stocks have been cited as a primary concern of money managers. In addition, other concerns have been raised over the possible dampening of the all-important Japanese export sector with the liberalization of the Japanese capital markets and expected strengthening of the yen.6/

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5/ "World Stock Market Review", Institutional Investor, 8/84.

6/ "Market notes from around the world," Financial World, 6/27-7/10/84.